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CALIFORNIA STATE TREASURER BILL LOCKYER

FOR IMMEDIATE RELEASE
November 21, 2008

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Treasurer Lockyer, Major California Bond Issuers Urge Federal Reserve Action to Treat Ailing Municipal Finance Market

Letter to Congress: Problems Hurting Taxpayers, Slowing Economic Recovery

SACRAMENTO – State Treasurer Bill Lockyer and officials from 19 major California bond issuers today launched a push for Federal Reserve action to fix short-term municipal finance market problems that harm taxpayers, further drain strapped budgets and slow infrastructure projects that can spur economic recovery.

"Throughout the meltdown of our financial markets, federal officials have acted as though state and local governments operate in some kind of parallel economy," said Lockyer. "We don't. The economic crisis has inflicted serious, widespread harm on our budgets and, much more important, on the taxpayers we serve. Mounting troubles in the short-term bond market are deepening those wounds. It's time for the federal government to help taxpayers, and help us provide jobs and a much-needed boost to our economy."

Jeffrey Kightlinger, general manager of the Metropolitan Water District of Southern California, which joined the State Treasurer's Office in spearheading this effort, said, "During these difficult economic times, state and local governments are an important part of the national economy that has been overlooked. Under this proposal, the federal government would provide necessary liquidity to the municipal marketplace, reducing the cost of borrowing and enabling state and local governments to proceed with critical infrastructure projects. This will help preserve jobs and support the battered economy – all without placing burdens on the federal taxpayer."

The California officials issued their call for Federal Reserve action in a letter to U.S. Sens. Dianne Feinstein and Barbara Boxer of California, U.S. House of Representatives Speaker Nancy Pelosi of California, and Rep. Barney Frank of Massachusetts, chairman of the House Financial Services Committee.

The letter cites "serious problems in the short-term municipal bond market caused by the current financial crisis." It adds, "These problems are burdening taxpayers with substantial costs, worsening state and local governments' budget woes, further destabilizing our banking and financial system, and hindering financing of infrastructure projects needed to help put us on the road to economic recovery."

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The short-term market problems stem from developments that have devastated bond insurers and weakened banks. Traditionally, those entities have backed variable rate bonds and commercial paper sold by governmental entities. Their support provided the liquidity that kept the short-term municipal market well-oiled. But many of those insurers and some banks have been downgraded by rating agencies. Other banks are operating under financial strain.

Taken together, the current conditions are freezing liquidity, sapping investor confidence and shrinking the market for municipal issuers' variable rate bonds and commercial paper. The result is higher interest rates, accelerated payments and other financial costs that taxpayers ultimately bear. One primary effect of higher borrowing costs and reduced liquidity is that infrastructure projects become more expensive and subject to delay.

"Historically, (the short-term) market has functioned because banks provide liquidity to guarantee investors a market in which to sell their bonds," the letter says. "Unfortunately, current financial disruptions have interrupted this market. Banks are less willing or unable to use their balance sheet to provide liquidity. Further, investors, worried whether weakened banks will provide the liquidity when needed, are selling their bonds as a precaution. The result is higher interest rates for many municipal issuers, the risk their debt will be accelerated, the possibility they will be forced to convert to a fixed rate in a very expensive and generally unaffordable market, and increased pressure on the banking system as banks use precious liquidity to purchase these bonds."

To alleviate those problems, the letter says, "We believe that the Federal Reserve should establish a program to provide much-needed liquidity to the short-term municipal bond market." The Federal Reserve could inject that liquidity in one of two ways, the letter suggests: by purchasing variable rate bonds that are sold to banks when investors cannot be found to buy them; or loaning money to banks so they can buy municipal variable rate bonds.

The proposed program would be "neither a bank bailout nor a municipal subsidy," but would benefit investors, banks and issuers, the letter states. "Investors will gain confidence that liquidity support will always be there … Issuers will benefit from a more stable market, lower interest rates and the ability to deliver critically needed infrastructure projects. This will help taxpayers by keeping down the cost of the municipal debt they support. And, it will help the economy by maintaining public works spending. Finally, it will provide liquidity and balance sheet relief to banks that are at the center of the financial market crisis."

Along with the letter, Lockyer's office and some of the other issuers detailed problems they have encountered in the short-term market. Those accounts are attached to the letter.

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